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No. 73-374

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In the Supreme Court of the United States

OCTOBER TERM, 1973

UNION EQUITY COOPERATIVE EXCHANGE, INC., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. A i-xii) is reported at 481 F. 2d 812. The findings of fact and opinion of the Tax Court (I-R. 47-48)[1] are reported at 58 T.C. 397.

JURISDICTION

The judgment of the court of appeals was entered on July 2, 1973. The petition for a writ of certiorari was filed on August 29, 1973. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether, in computing the amount of the allowable patronage dividend deduction of a nonexempt

[1] "I-R." and "II-R." are references to Volumes I and II of the duplicated record in the court of appeals.

cooperative, the courts below properly determined that cash dividends paid on the capital stock must be ratably charged against earnings derived from both member and nonmember business.

STATEMENT

Petitioner is an Oklahoma cooperative marketing association incorporated and doing business pursuant to the Oklahoma Cooperative Marketing Association Act, 2 Okla. Stat. Ann. 361 *et seq.*, and the federal Act of February 18, 1922, 42 Stat. 388, 7 U.S.C. 291-292 (the Capper-Volstead Act). From 1950 through the year ended March 31, 1963, petitioner did not qualify as a tax exempt cooperative under Section 521 of the Internal Revenue Code of 1954 (I-R. 49, 50).

In accordance with its prior practice, petitioner decided that in March 1963 all net earnings from member business would be distributed as patronage dividends to the members, while net earnings from nonmember business would first be transferred to surplus and then be paid out as a five-percent capital stock dividend (I-R. 52-53). For the taxable year ending March 31, 1963, petitioner's total net earnings before adjustments for patronage dividends and dividends on capital stock were $1,519,884.69, of which 57.18 percent ($869,070.07) represented earnings from member business (Pet. App. A iv; I-R. 53). During this year, petitioner paid $439,674.44 in cash dividends on its capital stock (I-R. 62).

In calculating its patronage dividends for fiscal 1963, petitioner made certain insignificant reductions in the $869,070.07 earnings from member business and distributed $861,795.83 as patronage dividends (65 percent in cash and 35 percent in capital stock). It claimed such amount as a deductible patronage dividend. From its

total earnings from nonmember business (42.82 percent of $1,519,884.69), petitioner paid its taxes, transferred the balance to its general or surplus reserve, and, out of the latter, declared and paid a five-percent capital stock dividend (Pet. App. A v; I-R. 53, 60). Petitioner used this computational method since 1950 without challenge by the Internal Revenue Service during prior audits (Pet. App. A xi).

The Commissioner rejected petitioner's method of computing patronage dividends, and ruled that the cash dividend of $439,674.44 must first be subtracted from the total earnings of $1,519,884.69. The deductible patronage dividend would then equal 57.18 percent of the remaining $1,080,210.25, or $617,664.22 (I-R. 60, 62, 63). The Tax Court and the court of appeals upheld the Commissioner, ruling that his determination was in accord with the basic principle governing cooperatives that patronage dividends must be paid solely out of earnings from member business (Pet. App. A vi-viii; I-R. 64-68).

ARGUMENT

1. A cooperative corporation, like all enterprises, requires capital investment and must often pay dividends on its capital stock in order to compensate investors for their risks. Unlike normal corporations, however, cooperatives usually restrict such dividends to a fixed percentage or amount, so that they may maintain their true cooperative character by returning their profits as "patronage dividends" to their patrons. Such patronage dividends are usually returned to the cooperative's patrons in proportion to their dealings with the cooperative during the year. In computing taxable income a nonexempt cooperative such as petitioner may deduct amounts paid to member and nonmember patrons

alike, in that such amounts are treated as a rebate of the profit which is made on the particular patron's business.[2] In order to qualify as deductible patronage dividends, however, distributions to member patrons must be out of profits or income realized on transactions with members rather than nonmembers. *Pomeroy Cooperative Grain Co.* v. *Commissioner*, 288 F. 2d 326, 328 (C.A. 8).

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[2]Prior to 1951, the deduction or exclusion of patronage dividends from the gross income of a cooperative was not recognized or sanctioned by any Internal Revenue Code provision. However, the deduction of patronage dividends by nonexempt cooperatives had long been permitted by administrative practice of the Treasury and the Internal Revenue Service. See, *e.g.*, *Des Moines County Farm Service Co.* v. *United States*, 324 F. Supp. 1216 (S.D. Iowa), affirmed *per curiam*, 448 F. 2d 776 (C.A. 8); *Clover Farm Stores Corp.* v. *Commissioner*, 17 T.C. 1265; *Farmers Cooperative Co.* v. *Birmingham*, 86 F. Supp. 201 (N.D. Iowa); *Puget Sound Plywood, Inc.* v. *Commissioner*, 44 T.C. 305; *Consumers Credit Rural Electric Cooperative Corp.* v. *Commissioner*, 37 T.C. 136, reversed and remanded, 319 F. 2d 475 (C.A. 6), on remand, 23 T.C.M. 149.

As early as 1918, the Treasury issued T.D. 2737, 20 Treasury Decisions, Internal Revenue 441, allowing the exclusion of patronage dividends paid by cooperatives to their patrons. The first statutory provision referring to this administrative practice appeared in the Revenue Act of 1951, 65 Stat. 452, Section 314(a). This Act added subparagraph (B) to Section 101 (12) of the 1939 Code (now Section 522(b) of the 1954 Code) to provide that patronage dividends for an *exempt* cooperative should "be taken into account in computing net income in the same manner as in the case of a cooperative organization not exempt."

The first statutory provisions explicitly permitting a nonexempt cooperative to deduct patronage dividends were contained in the Revenue Act of 1962, 76 Stat. 960, which added Sections 1381 through 1388 to the Internal Revenue Code (26 U.S.C.). However, these provisions apply only to taxable years beginning after December 31, 1962, and do not govern the taxable year ended March 31, 1963, which is at issue in this case.

As both courts below correctly held, petitioner's method of computing its patronage dividends deduction is not in accord with these basic principles governing cooperatives. By failing to deduct first the cash dividends from total cooperative earnings prior to allocating income between member and nonmember business, petitioner has charged the general expense of the cash dividend entirely against the earnings from nonmember business. This results in an artificially inflated figure for the earnings from member business and thereby produces a greater patronage dividend deduction. There is no warrant for such a method in either accounting or logic since the cash dividends were a proper charge against both member and nonmember earnings. As the court of appeals acknowledged in quoting with approval the statement of the Tax Court (Pet. App. A vii-viii; I-R. 67), this method incorrectly assumes that the "stockholders have invested only in those of petitioner's operations and assets which were used to transact nonmember business."

The Commissioner's method, which requires the initial reduction of cooperative earnings by the amount of any cash dividends paid on capital stock prior to a determination of the patronage dividend deduction, has the overwhelming and longstanding support of the authorities. *Producers Crop Improvement Ass'n* v. *Commissioner,* 7 T.C. 562; *Valparaiso Grain & Lumber Co.* v. *Commissioner,* 44 B.T.A. 125; *Farmers Union Cooperative Exchange* v. *Commissioner,* 42 B.T.A. 1200, appeal dismissed, 122 F. 2d 718 (C.A. 10); *Trego County Cooperative Ass'n* v. *Commissioner,* 6 B.T.A. 1275; *Des Moines County Farm Service Co.* v. *United States,* 324 F. Supp. 1216 (S.D. Iowa), affirmed *per curiam,* 448 F. 2d 776 (C.A. 8). Moreover, after many of

the judicially and administratively created principles governing cooperatives were added to the Code in 1962, the Commissioner's computational method was specifically adopted in Section 1.1388-1(a) of the Treasury Regulations and this aspect of the regulation has been upheld. *Des Moines County Farm Service Co.* v. *United States, supra.*

2. Contrary to petitioner's contention (Pet. 7-10), there is no conflict between the decision below or the Eighth Circuit's *Des Moines County* decision and that of the Fifth Circuit in *United States* v. *Mississippi Chemical Co.* 326 F. 2d 569, which warrants review by this Court. In *Mississippi Chemical,* the district court (197 F. Supp. 490) found as a fact that a computation similar to that urged by petitioner did not result in a diversion of profits from nonmember business to member business profits eligible for patronage dividends because the cooperative's by-laws permitted such an allocation. The Fifth Circuit affirmed on the ground that this finding was "particularly correct." Here, however, both courts below declined to make such a finding with respect to petitioner's total claimed patronage dividend deductions.

Moreover, while we disagree with the factual determination made in *Mississippi Chemical,* that case did not announce any legal principle contrary to that set forth either by the Tenth Circuit below or by the Eighth Circuit in *Des Moines County.* Significantly, the basis of the *Des Moines County* opinion was its approval of Section 1.1388-1(a) of the Treasury Regulations as a valid and reasonable construction of the statute. This Regulation, which was promulgated after the district court's decision in *Mississippi Chemical* and which was not considered by the Fifth Circuit, is in accord with the

decision below. In the light of these subsequent developments, it is by no means certain that petitioner would prevail had its case been presented to the Fifth Circuit. Thus, to the extent that *Mississippi Chemical* is deemed to represent a variant approach, its current validity is dubious.

3. Finally, petitioner erroneously asserts (Pet. 10) that the Commissioner's failure to challenge its method of computing patronage dividends in the prior 19 years equitably estops him with respect to the taxable year in question. It is well established that the Commissioner is not estopped from challenging erroneously reported items where Internal Revenue Service agents have failed in prior taxable years to challenge similarly erroneously reported items. *Automobile Club of Michigan* v. *Commissioner*, 353 U.S. 180; *Sanders* v. *Commissioner*, 225 F. 2d 629 (C.A. 10), certiorari denied, 350 U.S. 967; *Tollefsen* v. *Commissioner*, 431 F. 2d 511 (C.A. 2), certiorari denied, 401 U.S. 908.

CONCLUSION

For the reasons stated, it is respectfully submitted that the petition for a writ of certiorari should be denied.

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